AN ANALYSIS OF THE LEGAL AND FINANCIAL ASPECTS OF LONG-TERM CORPORATE CREDITORSHIP

BY

H. ROBERT POWELL

A.B., University of Illinois, 1949
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AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN ECONOMICS
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The purpose of this thesis is to discover and analyze the legal and financial aspects of long-term corporate creditorship. The significant question raised is the extent to which long-term creditorship as conceived in the law conforms to and reflects underlying financial and economic realities. In essence, this analysis centers around the functional aspects of long-term creditorship and the factors of significance relating to the nature of the long-term debtor-creditor relation. In general, the writer concludes that the legal conception of creditorship lags considerably behind the thinking in finance which is more closely attuned to business practice than is the law.

Long-term credit, contributing substantially to the financing of the operations of many business firms, reflects a permanent requirement for enterprise capital and at the same time investment needs of the capital market. Important cost advantages inhere, and a trading-on-the-equity policy is at least implicit, in much corporate borrowing.

Functioning as a capital contributor and risk bearer, the long-term creditor assumes a position unlike that conceived of in the law. Consider a principal characteristic of the long-term creditor's position. The borrowing enterprise promises unequivocally to pay both principal and interest at specific future dates. However, borrowing practices have the effect of subordinating the promise to repay the principal to business demands for capital on a permanent basis. Perpetual indebtedness, implemented partially by long terms to maturity and more or less nominal sinking fund provisions, involves the permanent financing of a portion of enterprise capital by means of indebtedness that is continually refunded at maturity. This practice is especially marked among the public utilities and railroads, and it implements a managerial attitude to the

effect that such debt is a device to afford investors (long-term creditors) a participation in the successes and the failures of an enterprise. Continuing success of the enterprise assures the ability to refund maturing debt, while economic and legal failure frankly means that the latter of the long-term creditor's contract cannot be realized; for in liquidation, the recovery of "sunk" capital is nominal in many cases, and in reorganization, sacrifices are usually required of all the parties at interest even though creditors are given prior rights in the recovery of their investments. In a sense, the creditors are "joint-adventurers" in a common hazard with the stockholders or proprietors.

For all practical purposes the issuance of bonds and notes with maturities extending beyond the span of a generation are confessions of perpetual indebtedness. In the light of the significant fluctuations in economic activity that have taken place in the past twenty-five years in this country, it is doubtful whether property can unquestionably retain its economic value beyond a generation or be projected into an unknown future far beyond the limits of human life. From the standpoint of the borrowing firm, the maturity of a bond or note issue fifty years or so hence, is of little import, the primary concern being the payment of contractual interest as it comes due from year to year. Thus, in the case of long-term bonds and notes, an essential feature of creditorship, the unequivocal promise to pay principal at maturity is of slight business significance. As a consequence, a degree of comparability exists between a long-term bond or note and preferred stock. Preferred stocks, of course, do not mature while the bond or note maturity need not necessarily be considered important.

The functional comparability of the long-term creditor's and stockholder's positions relative to enterprise operations and activities is reemphasized by a consideration of the distribution of the incidents of ownership: risk, income and control. Each of the long-term participants in the enterprise enjoys rights to income ranging from the "absolute" rights of creditors to the residual income rights of the shareholders.

The "control" over enterprise operations, traditionally attributed to the stockholders in the role of "ownership," is often nominal as the position of the individual stockholder in the modern large-scale corporation testifies. Although long-term creditors normally do not assume a direct voice in the activity of their debtors, often the indirect control implicit in the provisions of the borrowing agreement is of substantial significance.

Just as shares in the income and the control of a corporation are distributed among all the "equities," so are the risks characterizing the borrower's operations. Corporate stockholders, possessing limited liability, are able to shift to creditors a portion of the risk. The risks of income fluctuations, financial risks deriving from the make-up of the financial plan and secular risks are shared by all of the securities in varying degrees. The very nature of enterprise value, based upon the operating "whole," often precludes the recovery of more than nominal portions of invested capital in liquidation. Long-term creditors and stockholders are faced with the economic reality of a mutual dependence upon continued earning power rather than their legal rights for the recovery of their respective investments.

Examination of the investment motivations of long-term creditors and stockholders also emphasizes the positional comparability of these two broad classes of security-holders. Common stock investment, as contrasted with speculation, and long-term bond investment have similar objectives; that is, each is concerned with the reasonable safety of principal and the regularity of income despite the fact that bond indentures and stock contracts are wholly different in their specifications with respect to these factors.

Though legal theory conceives of the creditor as fundamentally an "outsider" and the stockholder as an "owner" in the traditional sense, the important considerations outlined above would seem to indicate a degree of sterility in the legal viewpoint. The legal theory derives primarily from the

distinctly dissimilar contractual rights of stockholders and bondholders.

An important feature of the long-term creditor's agreement with the debtor enterprise is the rigidity inherent in that agreement. That is, the unequivocal promises to pay interest and to repay principal at specific future dates are made without reference to the possibility of a changing economic context which might preclude the fulfillment of the obligation. In fact, reorganization procedure as at present conceived and utilized has as a primary objective the modification of inflexible claims and obligations no longer attuned to the altered economic and financial position of the borrowing enterprise. The rigid form of the debtor-creditor relation has serious implications for all the security-hodlers of an enterprise, because in the case of required alteration of the creditor's indenture agreement, appeal must be made to legal authority (the bankruptcy courts) in order to carry out the change. Assuming that the values to be preserved are in excess of those realizable upon liquidation, a reorganization may take place which has the effect of estopping the pursuit of creditors' legal rights established in law and set forth carefully in the underlying agreement between the debtor and creditor.

Rarely does the reorganization process result in the literal fulfillment of the creditors' legal rights, *i. e.*, the return of principal and interest. Obviously, if such were probable, there would have been little if any reason for the reorganization in the first place. Thus, the creditors' indenture agreement is not the controlling factor in reorganization. The ordinary technique of the modification of claims in reorganization is the exchange of the claims against the defaulted enterprise for new securities, usually of a legally inferior grade and of relatively uncertain value. A bundle of rights is given the participants in reorganization in exchange for the rights surrendered, while little reference is made to the original security contracts except to the extent to which they determine those who do and those who do not participate in the reorgani-

zation.

Firmly entrenched in legal theory is the observance of legal priorities in the allocation of new securities in reorganization. The doctrine of "absolute-priority," derived originally from the cases concerned with stockholder fraud upon creditors, is an expression of the contractual superiority of corporate creditors over stockholders. This doctrine represents the ideal guiding the allocations of new claims and interests to the original claimants of the enterprise undergoing reorganization. "Absolute-priority" insists upon the full compensation of senior "equities" prior to the inclusion of junior "equities" (usually stockholders) in the reorganization plan.

In application, however, the doctrine of "absolute-priority" has serious weaknesses.[1] This is so because in an important instance this must be greatly modified. In reorganizations involving a complex of conflicting rights and claims, it is very difficult to assure the "full compensation" of each surrendered right or claim before the inclusion of a legally inferior claim in a reorganization plan. The new securities created in reorganization are of fundamentally uncertain value, their par values serving as the measure by which the "fullness of compensation" is judged. The rulings of the Supreme Court in recent cases would seem to condone such quantitative compensation in contrast to qualitative compensation based on a market value test. As between the classes of security holders included in reorganization plans, the recognition of priorities seems to be positional or comparative, *i. e.*, relative rather than absolute. Ultimately, as the Supreme Court has indicated, the allocation of new securities in reorganization rests in the "informed discretion and judgment of the courts."

Another important factor may dictate departure from the "absolute-priority" principle in reorganization. In those instances in which the junior "equities" may be able to make

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1. The theory of "relative-priority," or the theory of "relative income position," represents in part a reaction to the weaknesses of "absolute-priority." Also significant in the development of the "relative-priority" theory is the functional and positional comparability of all long-term "equities" (bondholders and stockholders) of corporate enterprise as outlined above.

contributions of services or new capital to the reorganized firm in exchange for participation therein, the prior rights of creditors to "full compensation" are likely to be disregarded. A fundamental problem in nearly all reorganizations is the raising of new capital, and in the usual case, the stockholders are potentially the most probable source of that capital. Often, the value of participations offered the junior "equities" in exchange for cash contributions, of necessity, is in excess of the dollar value of the contributions. In this instance, the significance of new cash outweighs the sacrifices which creditors are called upon to assume.

The owner-manager situation presents another case in which the rights of creditors, though legally superior to those of stockholders, are subordinated to enterprise value considerations. Where the management of a business holds substantial stock interest and also contributes substantially to going-concern values, expediency dictates that the creditors allow the distribution of new securities to the stockholder-management.

Recent developments in railroad reorganization practice and legislative action have implications for the creditor's position similar to those noted above. The trend in the direction of pre-default adjustment of particularly pressing obligations is most notable. Passage of Section 20b of the Interstate Commerce Act in 1948 provides for the modification of the term of railroad indebtedness (and other claims also) with a view toward the elimination of the long and costly reorganizations consummated in the 1930's and the 1940's. The proposed adjustment process is extra-judicial and implies that the sacrifices necessary to avoid formal reorganization in bankruptcy will be shared by all parties at interest rather than being concentrated primarily among the junior claimants, *i. e.*, the stockholders. The desire to avoid formal reorganization is implicit in the increasing utilization of majority clauses in railroad indebtedness, permitting alteration of the terms of a bond, for example, upon approval by the majority (or a stated percentage) of the bondholders.

These more or less voluntary modification procedures are, in essence, attempts to substitute smaller losses for the serious losses often suffered by the entire heirarchy of security-holders in formal reorganization. Such pre-default adjustments are a partial recognition of the fact that business men often find it to their own interests to waive certain legal rights which they might enforce if it were only worth their while to do so. These adjustment procedures also implicitly recognize the mutual dependence of all security-holders, both bondholders and stockholders, upon the maintenance of going-concern values for the recovery of their capital commitments. The sacrifices which security-holders are called upon to make are aimed at the preservation of the going-concern.

A number of factors preclude the realization of the contractual rights of long-term corporate creditors. The inflexibilities of the lolng-term debtor-creditor agreement, presupposing a stability of enterprise values and capacities, in conjunction with the inevitable complications and problems of the reorganization procedure, generally result in decided departures from the terms and provisions of the indenture agreement existing between the borrowing corporation and the holders of debt claims.

Long-term corporate creditors, considered from the standpoint of function, security, and the effectiveness of their contractual rights, are not wholly different in kind from the stockholders. If it is true that the law in part derives from business practice and thinking the legal conception of the creditorship position is very likely to undergo some modification.

VITA

H. Robert Powell was born July 1, 1926 in New Haven, Connecticut. Following his graduation from Maine Township High School in Park Ridge, Illinois, in June, 1944, he served in the Army for a period of two years.

In the fall of 1946, he entered the University of Illinois and received a Bachelor of Arts degree in Liberal Arts and Sciences in February, 1949. He was then admitted to the Graduate College of the University of Illinois and was awarded the degree of Master of Arts in Economics in February, 1950. From that date until June, 1952, he held a Graduate Assistantship in Economics while continuing his graduate studies.